

Statement of Thomas R. Saving
Public Trustee of the Social Security Board of Trustees
before the
Senate Special Committee on Aging
July 29, 2003

As Congress considers legislation to reform Social Security, it is important to understand the program's financial condition. In less than a decade the combined Social Security and Medicare programs will go from providing net revenue to the Treasury to requiring a significant revenue transfer. Even though this year's Trustees' Report shows slightly better short-term news coupled with slightly worse long-term news, from the perspective of the total federal budget, these programs will impose significant costs even in the near term. The fact that the Trustees 2003 estimate of the Trust Fund exhaustion date is 2042 has no bearing on the demands that Social Security and Medicare will place on the rest of the budget beginning in just a few years. This total budget perspective is important, because though Social Security and Medicare HI have Trust Funds, when revenues into the combined system fall below expenditures, real resources must come from somewhere else in the federal budget.

There are a few years of good news from the total budget perspective. Social Security and Medicare Part A payroll tax revenues currently exceed expenditures. These surpluses are sufficient to cover almost all of Medicare Part B expenditures that are not paid by premiums. This year and next, the combined programs of Social Security and Medicare Parts A and B are expected to require only a small transfer from the U.S. Treasury. For several years thereafter, as Figure 1 shows, the forecast is that Medicare and Social Security payroll tax revenues will be sufficient to actually provide revenues to the rest of the budget. However, in fewer than five years, beginning in 2008 and in all subsequent years, these programs will become a drag on the federal budget.

By 2010, in less than seven years, these programs will consume 1.5% of total federal income tax revenues, an amount that will accelerate rapidly. By 2020, just two years after the Trustees project that Social Security expenditures will first exceed revenues, the two programs together will be using 17.5% of all federal income tax revenues in addition to dedicated tax revenues. Rather than providing funds that add to federal income tax revenues, these programs will require a transfer from these same federal income tax receipts and begin to impinge on other federal programs.

The problem does not end in 2020, as the required transfers will continue to grow rapidly. By 2025, in order to maintain current program benefits, Social Security will require that almost 9% of all federal income tax revenues be transferred to beneficiaries. Moreover, Social Security and Medicare together will use up nearly 28% of all federal income tax revenues in 2025. As depicted in Figure 2, the total transfer will grow to more than 36% (13% for Social Security) of federal income tax revenues by 2030, and by 2040, just two years before the current estimate of Social Security Trust Fund exhaustion

and almost ten years before newly entered workers will retire, these programs will require over 47% (15.3% for Social Security) of total federal income tax receipts.

In spite of Medicare reform getting most of the current press, Social Security's financing future is ominous. This year, Social Security will contribute to the Treasury the equivalent of 6.5% of total federal income tax receipts. By 2020, just seventeen years from now and still at the beginning of the baby boomer retirement wave, Social Security will require a transfer of more than 3.4% of all federal income tax receipts to pay benefits forecast by the Trustees under current law. This transfer will grow rapidly so that by 2042, the year the Trustees forecast that the Social Security Trust Fund will be exhausted, it will reach 15.5% of all federal income tax revenues. In that year, we will be transferring to Social Security beneficiaries some \$427 billion in today's dollars, out of projected federal income tax revenues of \$2.76 trillion, as Figure 2 shows. Importantly, the size of the required transfer will remain almost the same in 2043, when the transfer must be \$438 billion in today's dollars, out of projected federal income tax revenues of \$2.81 trillion. Thus, the Trust Fund and its exhaustion date play no role whatsoever in the amount of resources that must be transferred to Social Security beneficiaries if the current program remains in place. At best, the Trust Fund is simply a commitment by Congress to find the money and not a source of any funding. At worst, it may provide solace for some and delay changes necessary to address the coming shortfalls in Social Security funding.

Clearly, elderly entitlement programs are out of control. If nothing is done, by 2060, the combination of Social Security and Medicare will account for more than 71% of a federal budget that remains at the current budget's share of the nation's gross domestic product. By way of comparison, these two programs today account for only 35% of federal expenditures.

These numbers, while staggering, are not meant to frighten, although they are frightening. They are based on the best estimates that we as Trustees of the Social Security and Medicare trust funds are able to put together. If not meant to frighten, they surely represent a sobering reality.

The tax requirements we have just considered quantify the annual resources the nation will have to transfer to the elderly in coming years. However, the debt implied by these future transfers over and above the programs' dedicated revenue sources can be quantified today. The promises implied by the Social Security and Medicare programs are essentially debts that must be paid by future taxpayers.

Since we are discussing Social Security today, its obligations will be the focus of my remaining comments. The Trustees now report several alternative measures of Social Security's unfunded obligations including the 75-year unfunded obligation, the 100-year closed group unfunded obligation and the perpetuity unfunded obligation. Reviewing these different measures is an instructive way to evaluate the generational burdens of the program. The components of the 75-year unfunded obligation, that is, the expected tax

revenues, benefit payments, and the Trust Fund are presented in Table 1 and come from Table IV.B6 in the Trustees report.

The table shows that in addition to current dedicated tax revenues, if scheduled benefits are paid and scheduled tax rates remain unchanged, \$31.4 trillion 2003 dollars having a present value of \$4.9 trillion, will have to be transferred to Social Security over the next 75 years. Moreover, at the 75th year and for all years thereafter, the program will experience deficits indicating that a more complete accounting is needed to describe the full cost of the system under its current rules.

This more complete accounting is now presented in two new tables from the Trustees Report: Tables IV.B7 and IV.B8. These tables report the perpetuity unfunded obligation and the 100-year closed group unfunded obligation. The two measures allow us to divide the total burden of the system between current generations and future generations. The simple equation below expresses the idea that the all generation unfunded liability must equal the sum of unfunded liability of the current generations plus the unfunded liability of future generations.

$$\begin{array}{lcl} \text{All Generations} & = & \text{Current Generations} + \text{Future Generations} \\ \text{(Liability or Asset)} & & \text{(Liability or Asset)} \quad \text{(Liability or Asset)} \end{array}$$

If we keep Social Security unchanged for all those 15 years old and older and then calculate the difference between scheduled benefits and taxes until the last of this group is expected to be deceased, we have an estimate of the debt we owe to current generations. This debt is often referred to as the 100-year closed group unfunded obligation. It is considered a closed-group, because only the tax payments and benefit receipts of current beneficiaries and workers enter into the calculation. The calculation ends in the 100th year, because the youngest members in the group today are 15 and are expected to be deceased on or before the end of their 115th year.

The perpetuity unfunded obligation is the unfunded liability of all generations, present and future, and the difference between the two is the liability or asset of future generations beginning with those who turn 15 years old tomorrow. If the current Social Security system was sustainable, the all generations unfunded liability would be zero, and the debt owed to current generations would be completely offset by the taxes imposed on the next 100 years of new entrants. This separation of the liability allows for a complete evaluation of changes to the system since it accounts for all costs and benefits, not just for current members but also for those who enter the system tomorrow and thereafter.

Table 2 reports the 100-year closed group obligation along with the perpetuity unfunded obligation and the contribution of future generations. As the first row of the table indicates, if current scheduled benefits and taxes remain in place, future generations will have to pay the current generations \$11.9 trillion debt. However, under currently scheduled benefits and taxes, they will contribute nothing toward this debt, as shown in the second row of the table. If the Social Security system was solvent, the future generations would be paying taxes sufficient to make their contribution to the debt of

current generations exactly \$11.9 trillion. Thus, the fact that the Trustees estimate that future generations will contribute nothing toward the debt owed current generations is further evidence that Social Security, as it is currently constituted, is insolvent.

Table 2 reports the value of the Social Security Trust Fund that, in Table IV.B8 in the Trustees Report, is treated as an offset to the liability owed to current generations. However, as I have pointed out above, the Trust Fund has no effect on the magnitude of the transfers necessary to pay scheduled benefits. The Trust Fund simply indicates a commitment by Congress to provide funding but does not provide a source of the required funding. Thus, the present value of funding, in addition to scheduled payroll taxes that must be raised by Congress to provide for scheduled benefits, is the full \$11.9 trillion owed to current generations.

Between now and the time it takes for the baby boomers to move through retirement, we will have to pay off most of the closed group debt. In doing so we must bear in mind that the retired baby boomers are going to eat real food, live in real houses, drive real cars and use real hospitals, doctors and nurses. The young will have to produce all this output, essentially paying off the huge debt by consuming less while the retired baby boomers consume more of the nation's output.

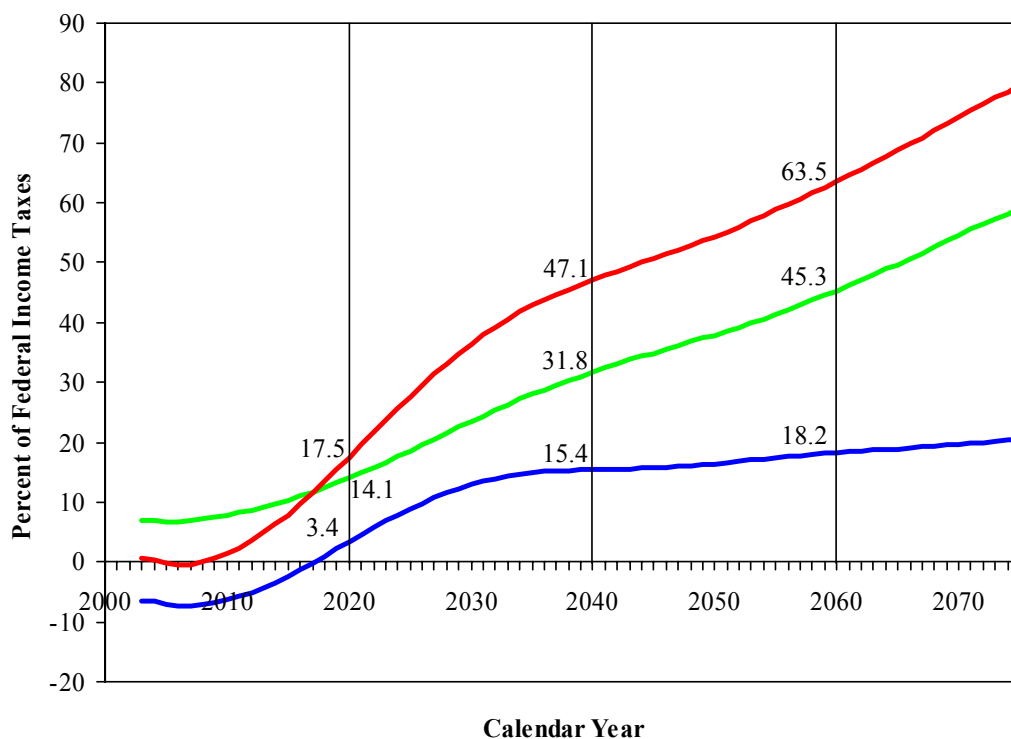
A measure of how much less future generations will have for their consumption can be had by examining the payroll tax rate that would have to be imposed to pay for Social Security and Medicare if we continue to provide scheduled benefits. Figure 4 shows estimated payroll tax rates that would provide revenue sufficient to pay scheduled benefits for Medicare and Social Security. Importantly, by 2030 the required payroll tax rate would be almost 27% and by 2040 would exceed 30%. Moreover, these tax rates assume that the fact that the young have less to consume has no effect on the nation's means of production or capital stock. However, tax rates at this level would significantly affect capital accumulation and labor supply. Thus, the magnitude of the coming financial crisis in the provision of elderly entitlements via generation transfers, has the potential to reduce national income and economic growth.

Conclusion

In the debate concerning changes necessary to assure the future of Social Security, it is important to consider how these changes will impact on future participants. The deficits projected by the Trustees in the *2003 Annual Report of the Board of Trustees* are especially significant. If no changes are made in Social Security and Medicare, they will rapidly become the tail that wags the federal budget dog. By 2030, Medicare alone will require more than 21% of all federal income tax revenues. When coupled with the transfers to pay currently scheduled Social Security benefits, total transfers of general revenues to keep these programs intact will require more than 35% of federal income tax revenues in 2030. If other federal programs are to remain at anything like their current size, dramatic action will be required.

Fundamental reform can revitalize Social Security while reducing government debt. Over the short term, reform is expensive. Over the long term, reform reduces taxes and restores Social Security to a sound fiscal position. Total reformed benefits exceed the amount payable under the current system and exceed the purchasing power of today's benefits. Reform will eventually benefit recipients and workers alike. Even if Social Security is reformed, the even larger Medicare debt will remain. As we have seen, Social Security will require substantial transfers from the rest of the federal budget. An alternative to these future transfers is to have people save more for their retirement. Additional savings now can be used to lessen the tax burden required under the present financing arrangement.

Figure 1. Social Security and Medicare Funding Shortfalls as a Percent of Federal Income Taxes



Source: 2003 Social Security and Medicare Trustees Report and author's estimates

Figure 2. General Revenue Transfers to Social Security and Medicare (as a % of income taxes)

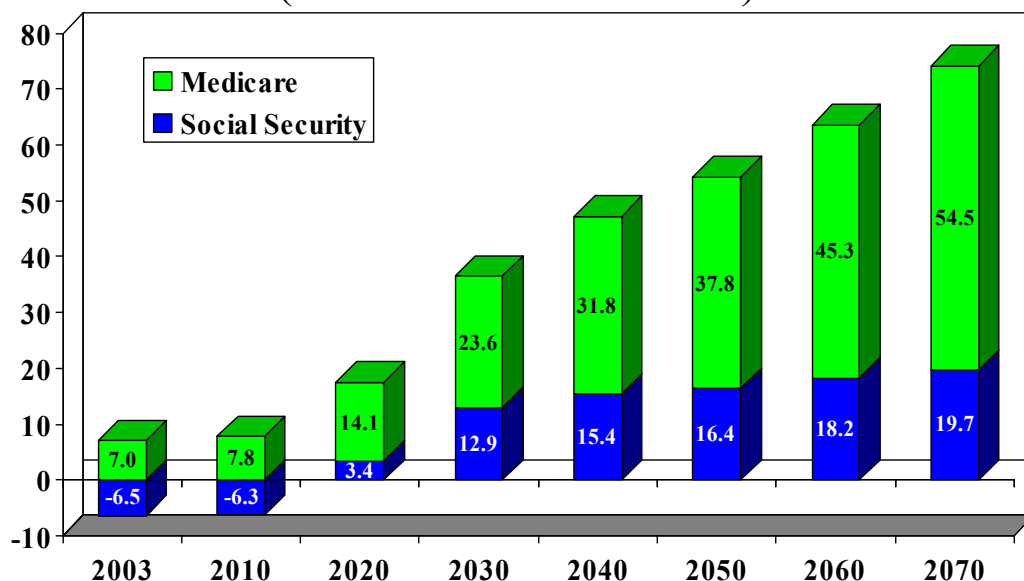
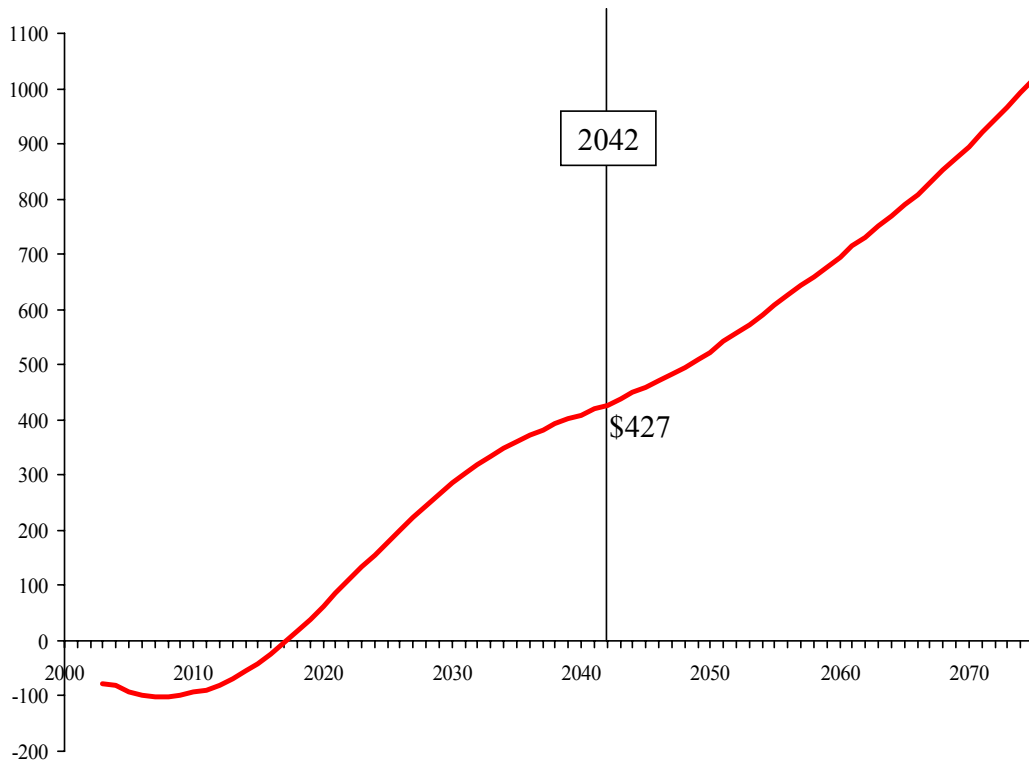
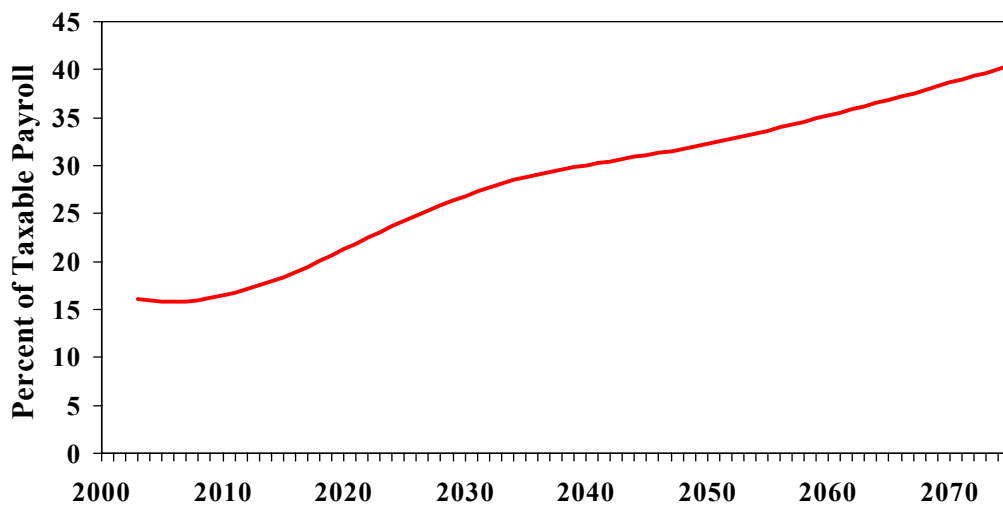


Figure 3. Social Security Surpluses and Shortfalls in 2003\$



Source: 2003 Social Security Trustees Report

Figure 4. Projected Social Security and Medicare Costs as a percent of Taxable Payroll



Source: 2003 Trustees Report (OASDI), Table VI. F2. Part B costs are from Table II.A3 in the Medicare Trustees Report.

Table 1

Components of the 75-Year Social Security Unfunded Obligation
(2003)

Component	Present Value (in billions)
Tax Revenues	\$26,147
- Benefit Payments	31,075
= Additional Future Resources Required	4,927
- Trust Fund	1,378
= 75-year Open Group Unfunded Obligation	3,550

Table 2

Components of the Perpetuity Social Security Unfunded Obligation
(2003)

Component	Present Value (in trillions)
Current generations' liability	\$11.9
+ Future generations' liability	0.0
= All generations' liability	11.9
- Trust Fund	1.4
= Perpetuity Unfunded Obligation	10.5